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D&O INSURANCE RESCISSION ISSUES

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The material in this outline is not intended to provide legal advise as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

Because D&O insurance typically affords claims-made coverage for prior Wrongful Acts, underwriters must safeguard against insuring known risks or proverbial “burning buildings.” The process of underwriting D&O policies is primarily focused on obtaining and evaluating information that may be helpful in predicting the likelihood of a future claim. When a claim is subsequently made during the policy period for a wrongful act predating the policy period, a natural question by the Insurer is whether the Insureds knew about the likelihood of the claim during the underwriting process and whether any information submitted during the underwriting process was false, thereby preventing the underwriter from anticipating the claim.

From an Insurer’s perspective, it is very important the Insurer has an effective remedy if the Insureds submitted false underwriting information. That remedy usually is rescission of the Policy. From an Insured’s perspective, it is very important that the Policy is not rescinded and the full coverage is preserved, particularly if the Insured was not aware of the false information submitted to the underwriters. Therein lies the dilemma of rescission: both the Insurer and the Insureds have very compelling yet opposite concerns and goals.

The following discussion briefly analyzes these issues and how courts, as well as the insurance market are dealing with these issues.

I. RESCISSION ISSUES

If information submitted to the Insurer during the underwriting process is false, the Insurer’s primary remedy is potential rescission of some or all coverage under the Policy. If successful, such rescission voids the coverage *ab initio* (i.e., “from the beginning”), and thus the coverage is deemed to never have existed. The theoretical justification for this remedy is that the Insurer would not have agreed to issue the Policy at the agreed upon terms if the true facts had been disclosed to the Insurer, and therefore the Insurer should not be required to provide the coverage which was obtained under false pretenses.

The elements required for rescission vary from state to state, and are typically set forth in statutory and/or common law. As a result, important choice of law issues can arise as to which state law should governs rescission of a policy. In general, choice of law concepts provide that the law of the state in which the policy was formed governs that policy. Thus, the law of the state where the Insured is headquartered usually applies. However, some insurance policies contain explicit choice of law provisions, which are almost universally upheld by the courts as long as the selected state has a substantial relationship to the parties or the dispute.

Although the specific requirements for rescission differ from state to state, generally an Insurer must prove some or all of the following five elements: (1) the making of a representation; (2) the falsity of the representation; (3) the materiality of the misrepresentation; (4) the Insurer’s reliance on the misrepresentation; and (5) the Insured’s knowledge of the representation’s falsity (i.e., scienter). Virtually all states require the first four of these elements, but only some states require the fifth element. Each of these elements of rescission is briefly discussed below.

A. Making of a False Representation

The first two elements of rescission are common to all states: the Insurer must establish that the Insured made a representation, and that the representation was false. Usually, these elements are not in dispute if the Insurer can establish that the Insured's answer to a question in a signed Application is false. In addition to the question of what information is considered part of the Application (which is discussed in Section II below), the issues most frequently arise with respect to these two elements where the Insured submits an unsigned Application, where no written Application is submitted, or where the Insured fails to disclose to the Insurer material information even though such information was not requested by the Insurer.

Failure of the Insureds to sign an Application does not necessarily bar a successful rescission action. Where the Application is unsigned, the Insurer may still be entitled to rescind the policy if the Insurer can otherwise establish that the representations in the unsigned Application were made by the Insureds.

Even in the absence of a written Application, the Insurer may still be able to argue that an Insured made misrepresentations which entitle the Insurer to rescind coverage. Although there is limited case law directly on this point, a few cases recognize the possibility that oral representations made to an Insurer outside an insurance Application can be the basis for a rescission action. As a result, Insureds should carefully evaluate the accuracy of all written or oral information provided to the Insurer either by the Insureds or their broker and should document for future reference all such information. Any information conveyed to the Insurer by the Insureds or broker during the underwriting process can potentially give rise to allegations of misrepresentation even if the information is technically not part of the Application.

Omission of material information not specifically requested by the Insurer typically is not a basis for rescission in the United States. As a general rule, in the United States (unlike United Kingdom law) Insureds are not required to furnish information to the Insurer unless the information is specifically requested by the Insurer. Therefore, even if the omitted facts are material to the risk being insured, the omission cannot be the basis of rescission unless the information was specifically requested by the Insurer. A few courts recognize a narrow exception to this rule and allow a material omission to be the basis of rescission if the omission constitutes intentional fraud by the Insured (i.e., a deliberate intent to withhold information in order to mislead the Insurer).

B. Materiality

Almost every state requires that the Insured's misrepresentation be material in order to justify rescission of the policy. In a majority of states, a misrepresentation is deemed material if it influenced the Insurer's acceptance of the risk, calculation of the premium charged, or estimation of the risk involved. In other words, the Insurer must prove it would not have issued the policy, or at least would have required different terms or premium, if the Insurer had known the true information. However, a minority of states requires the Insurer to establish that it would not have issued the policy at all had it known the truth of the matter misrepresented. If knowledge of the truth would have merely caused the Insurer to increase the premium charged or

change the conditions and terms of the policy, the Insurer would not be permitted to rescind in these states.

Regardless of which standard of materiality is employed, evidence for this element is usually provided by testimony from the underwriter(s) as to how knowledge of the truth would have changed the underwriting analysis. Materiality can also be shown through the Insurer's practice of accepting or rejecting similar risks, written underwriting standards or guidelines adopted by the Insurer, or other written documentation of the underwriting process.

To determine materiality, most courts focus on whether knowledge of the truth would have reasonably influenced the decision of the underwriter. The testimony of the underwriter is frequently the only evidence presented on this issue. However, a few courts have not permitted the Insurer to rescind where the only evidence of materiality is the subjective testimony of its underwriter, rather than objective evidence of its underwriting practices and criteria, such as written underwriting manuals or rules.

C. Reliance

In addition to the materiality of the misrepresentation, most states require an Insurer prove that it relied on the Insured's misrepresentation in its underwriting of the policy. Reliance is usually considered closely related to materiality, and some courts interchange these two elements.

Under most states' laws, the Insurer must merely establish through the testimony of its underwriters that the Insurer reasonably relied on the information furnished by the Insured in connection with the underwriting of the policy. In addition, almost all states provide that the Insurer is under no obligation to independently investigate the statements contained in an Application beyond its regular underwriting practices. The Insurer is only under a duty to investigate if it has knowledge of information that warns of the falsity of answers in the Application.

If the underwriter did not review and consider certain information, that information cannot be a basis for rescission by the Insurer, even if the information is expressly included within the Application. For example, if the Policy defines the Application to include certain SEC filings or an application submitted to another insurer, the Insurer can later rescind coverage based on misrepresentations in those documents only if the Insurer can prove its underwriter read and relied upon such misrepresentation.

D. Scierter or Intent

A slight majority of states (including New York and California) require only that an Insurer establish that a material misrepresentation was made by the Insured and was relied on by the Insurer in order to rescind the policy. The remaining states also require proof of some sort of intent to deceive by the Insured in order to rescind. The specific requirements of this scierter element vary from state to state. For example, some states require the Insurer to establish that the Insureds specifically intended to deceive the Insurer in connection with the underwriting and issuance of the policy. In contrast, other states merely require the Insurer to show that the Insured either knew the information was false when published or acted in bad faith, such as by

making a false statement without any knowledge as to its truth or signing the Application without reviewing the contents to ensure they are correct. For this reason, persons completing and signing the Application should undertake and document reasonable efforts to determine the truth of information contained in the Application, including the polling of directors and officers to the extent feasible.

Under the latter version of this intent element, the Insured need not intend to specifically deceive the Insurer, and in fact need not even know what was disclosed to the Insurer. Instead, knowledge of a false publication to third parties generally is sufficient. Thus, Insureds who are not involved in the Application process may satisfy this intent requirement and lose coverage. Many D&O policies expressly confirm this result by stating that for purposes of rescission, an Insured need only know the facts that were not truthfully disclosed to the Insurer, and need not know that the facts were misrepresented to the Insurer. Thus, coverage may be rescinded as to an Insured whether or not the Insured was involved in the Application process.

E. Attached to Policy

As a condition to rescission based upon false statements in an Application, a few states require the Application be physically attached to the policy. A statement in the policy or Application that the Application is deemed to be attached and incorporated into the policy is probably not sufficient to satisfy this requirement. The Insurer and Insureds should therefore check relevant state law to determine whether actual attachment of these materials to the policy is a required element for a successful rescission action.

F. Unilateral Rescission

Historically, when an Insurer concluded all of the elements for rescission existed, the Insurer frequently would notify the Insureds the Policy was rescinded, return the Policy premium, and refuse to pay any amount under the Policy because the Policy was void. Thereafter, the Insureds and the Insurer litigated the issue whether the Policy was properly rescinded.

Several recent cases have held that an Insurer cannot unilaterally rescind a D&O Policy, but instead must pay any loss otherwise covered under the Policy until a court rules that the Policy is rescinded, at which time the Insurer would have the right to seek repayment from the Insureds of the loss previously paid under the Policy. In many instances, that type of scenario will leave the Insurer with no effective relief even though the Insurer is entitled to rescind the Policy. It frequently takes several years to obtain a judicial determination of the Insurer's right to rescind, by which time the defense costs and/or settlement in the underlying claim may significantly reduce or exhaust the Policy's limit. If the Insurer is unable to recoup from the Insureds its payments under the Policy, the court's subsequent determination that the Policy is rescinded is a hollow victory for the Insurer.

II. APPLICATION INFORMATION GIVING RISE TO RESCISSION

The two provisions in a D&O Application which most frequently create potential rescission issues are the so-called "warranty" statement and various information incorporated into the Application.

The “warranty” provision states that no Insured Person is aware of any matter which may give rise to a future claim. Such a warranty provision is generally included only within the Application for the initial D&O policy purchased by a Company from an Insurer, and usually is not included within a Renewal Application since in the renewal context, the Insurer is already on risk for the potential claim. However, if at renewal the Insurer increases its limit of liability or lowers its attachment point, the Insurer may require a warranty statement for the increased limit or lower attachment. In that event, Insureds should seek to have the warranty expressly apply only to the extent the limit is increased or the attachment is lowered.

These warranty provisions vary among Application forms in two primary respects. First, some provisions refer to known “facts, circumstances or situations,” whereas other provisions refer to known “acts or omissions.” The former approach is more encompassing since it does not require knowledge of specific conduct by Insured Persons which could give rise to a claim, but rather general circumstances (such as a restatement of financials) which could give rise to a claim even though no specific wrongdoing is then known. Second, the language describing the likelihood of a future claim varies among Applications. Some provisions require disclosure of known information that “might” or “may” give rise to a future claim, whereas other Applications require disclosure of known information only if the information is “likely” or “reasonably likely” to give rise to a claim.

Courts interpreting these “warranty” provisions generally apply both a subjective and objective test to determine if the warranty statement was correct. The Insurer typically must prove that the Insured Person subjectively knew of the circumstance or wrongdoing which could give rise to a future claim, but need not show that the Insured Person actually realized that such information may give rise to a future claim. Rather, an objective analysis is usually applied to determine whether a reasonable person with actual knowledge of the circumstance or wrongdoing would believe that a future claim could be made as a result thereof.

The second type of Application information which most frequently creates coverage issues is the information incorporated into the Application. In addition to a signed Application form, D&O Insurers typically require the Insureds to submit other documentation, such as financial statements and certain SEC filings, as part of the underwriting process. To avoid the administrative burden of handling those voluminous documents, many Applications today incorporate by reference the Company’s publicly available filings with regulators (or at least the SEC) for some period of time. These attached or incorporated documents can be the basis for the Insurer’s rescission of coverage if the information in the documents is false. As a result, it is important to clearly identify what information is attached or incorporated into the Application and to assure all such information is truthful. If the information is time sensitive, the date of the information should be clearly stated. Most Applications require the Applicant to update any information in the Application if the information materially changes prior to inception of coverage. Insureds should either expressly disclaim such an obligation to update attached documents or evaluate whether the attached documents should be updated to satisfy the Insurer’s requirements.

III. REPRESENTATIONS VS. WARRANTIES

The elements of rescission summarized above apply to rescission based on misrepresentations to the Insurer. Some states recognize a distinction in the insurance context between misrepresentations and breach of warranties made by the Insured. In contrast to a misrepresentation, breach of a warranty can entitle an Insurer to rescind a policy without proving materiality, reliance or scienter because the mere falsity of the warranted information is sufficient to void the policy *ab initio*. This means that it is much simpler for an Insurer to rescind a policy due to an Insured's breach of warranty as opposed to a misrepresentation.

Because breach of warranty requires a lesser standard of proof than a misrepresentations, courts are often reluctant to construe statements by Insureds as warranties, and statutory or common law in many states provides that statements in an insurance Application either constitute or are presumed to constitute representations and not warranties. Although not determinative, the label used in the Application to describe the information as either a "warranty" or a "representation" can be important and should conform to the intent of the parties.

IV. SEVERABILITY

As a general rule, courts have held that absent special policy language, the misrepresentations of any one Insured in an Application can void the policy as to all Insureds, provided the Insurer can establish the requisite elements for rescission with respect to any one Insured. However, D&O policies can, and usually do, include a "severability" provision which protects the coverage for so-called innocent Insureds even if one or more other Insureds misrepresented information to the Insurer.

There are several different types of severability provision which are commonly included in D&O policies and/or Applications. A "full" severability provision states that the Application is deemed to be a separate Application by each Insured and that no knowledge of one Insured is imputed to any other Insured. If the policy includes entity coverage, this full severability provision may state that only the knowledge of certain executive officers is imputed to the company for purposes of determining coverage. Some Insurers use a more limited form of severability, which, for example, states that the knowledge of either the signer of the Application or, alternatively, any Executive Officer is imputed to all Insureds. Under such a provision, coverage for all Insureds could be rescinded if the signer of the Application or any Executive Officer knew of the false information which was not properly disclosed to the Insurer. If Insureds other than the signer or an Executive Officer knew such information, severability would apply and the Insurer would be able to rescind only with respect to the Insured who knew of the misrepresentation. Several recent court decisions have upheld this type of limited severability and have permitted the Insurer to rescind the entire policy based on the knowledge of the signer of the Application.

In today's market, where full severability is quite common, the most common severability debate relates to how severability applies to the corporate reimbursement coverage under Insuring Agreement B. If the Company is deemed to have made misrepresentations to the underwriters, does the Company lose all of its coverage under Insuring Agreement B or just

coverage for the Company's indemnification of Insured Persons who knew the false information? Many policies do not clearly answer that question.

Because of the uncertainties surrounding the severability issues and the disastrous consequences to directors and officers if their Policy is rescinded, many Side-A Policies expressly state that the Policy may not be rescinded in whole or in part for any reason. A few standard D&O Policies contain a similar provision, but only with respect to Insuring Agreement A (i.e. the Insurer can still rescind coverage for the Company under Insuring Agreements B and C).

V. WARRANTY EXCLUSION

In some situations, an Insurer may have an option of excluding coverage rather than rescinding coverage based upon a misrepresentation in the Application. For example, many Applications include an exclusion as part of the warranty statement, which states that if circumstances or wrongdoing which could give rise to a future claim exists prior to inception of coverage, any subsequent Claim arising from such circumstances or wrongdoing is excluded from coverage.

The consequences to the Insurer and the Insured vary significantly depending upon whether the Insurer elects to rescind or exclude coverage. If coverage is rescinded, the Insurer must return to the Insured the premium paid for the policy, and the policy is deemed to have never existed for any claim. On the other hand, if coverage is excluded, the policy remains in full effect for non-excluded claims and no premium is returned to the Insured. In addition, it is usually easier for an Insurer to invoke the exclusion rather than rescind coverage, since the elements of rescission summarized above do not apply to an exclusion from coverage.

As a result, some Insurers are endorsing to the D&O policy a warranty exclusion in lieu of or in addition to a warranty statement in the Application. Such an approach not only raises fewer questions in the claims context, but also avoids the necessity for a senior officer of the insured company signing the warranty statement. However, if such a warranty exclusion is utilized, the parties should confirm the intended applicability and the appropriate type of severability provision for such an exclusion. For example, a limited severability provision which does not apply to knowledge of the signer of the Application may not be appropriate for a warranty exclusion where no Application is signed.

VI. RESTATED FINANCIAL STATEMENTS

Both original and renewal Applications typically require submission to the Insurer of the company's current financial statements. Those financial statements usually are considered a part of the Application and incorporated into the policy when issued. If those financial statements are later restated, the Insurer may argue that the Application contained material misrepresentations which may allow the Insurer to either exclude claims relating to the restatement or to rescind the policy as void *ab initio*. Like the plaintiff shareholders in the underlying claim, the Insurer can persuasively argue that it relied to its detriment upon the erroneous financial statements. In essence, the Insurer would argue that the company the Insurer thought it was insuring was far different (from a financial standpoint) than the company it in fact insured.

In states where Insurers need not prove scienter to rescind an insurance policy, virtually any restatement of financial information included within the Application arguably gives rise to a rescission of the entire D&O policy. In such a state, a severability provision which simply states that knowledge of one director or officer shall not be imputed to any other director and officer arguably has no relevance since knowledge of the Insureds is not an element of rescission.

To avoid this harsh result, Insureds may argue that the Insurer is required to prove intent or knowledge (notwithstanding applicable state insurance rescission law to the contrary) if the Application states that the person signing the Application declares to the best of his or her knowledge, after reasonable inquiry, that the statements contained in the Application are true. Under this language (which appears in some but not all D&O Applications), Insureds may argue that the Insurer must prove the falsity of this representation in addition to the falsity of the attached financial statements in order to rescind the policy or exclude coverage with respect to the restatement claim. In other words, coverage could be rescinded or excluded only for directors or officers who knew or should have known of the falsity of the financial statements. However, this declaration in the Application (if it exists at all) may be viewed by the Insurer and by a court as applying only to the answers and statements of the Insureds in the Application form itself, and that misrepresentations in separate documents which are attached to or incorporated into the Application are arguably not limited by the “best of knowledge” and “reasonable inquiry” provisions in the Application.

An alternative type of severability provision states that the Application shall be deemed to be a separate Application by each Insured director and officer. This type of provision likely would provide no protection to the Insureds since the false financial statement would be deemed attached to each separate Application of each director or officer. Thus, the false financial statements would taint each director or officer’s Application.